Economic Outlook

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May 1986

The economy is being tugged and pulled in opposite directions by various sectors. Housing is a strong spot now, while exports are being boosted by the depreciation of the dollar. Industrial production continues to fall, however, with much of the weakness in oil-related activities. Despite the softness in the industrial sector, real GNP rose at a 3.2% annualized rate in the first quarter and is estimated to be rising at a 2.8% rate in the current quarter. Given the substantial depreciation of the dollar, the generally favorable effects of low oil prices, and the declines in interest rates since mid-1984, it seems likely that the economy will be experiencing stronger growth later this year and early next year.

Early in 1985, when the dollar was at its recent peak, the strains in the U.S. industrial sector were severe. Because of the strong dollar, the market shares of numerous industries were being eroded by imports into the United States, while their products had become uncompetitive abroad. The depreciation of the dollar since then has turned U.S. exports around. Merchandise exports in real terms fell steadily from the fourth quarter of 1984 through the third quarter of 1985. They then rose at a 9.6% annualized rate in the fourth quarter of last year and at an 18.0% rate in the first quarter of this year--a striking reversal. Moreover, despite the volatility of the merchandise trade data, the first quarter rebound was not just a fluke; every major category of exports rose.

The outlook seems particularly bright for narrowing our trade deficit with Western Europe. The dollar has fallen slightly more than a third against several Western European currencies. Moreover, the recent improvement in economic growth prospects in Western Europe indicates a more favorable outlook for U.S. exports to this region. Although the U.S. ran a trade deficit of $27.4 billion in 1985 with Western Europe, as recently as 1982 the U.S. had a trade surplus of $5.3 billion with the region. One category that may show particular improvement in the trade balance with Western Europe is industrial materials, which are especially sensitive to shifts in exchange rates.

Business capital spending is now a drag on the economy. Real business capital spending fell 13.6% at an annual rate in the first quarter, after rising 9.7% in 1985 and 19.5% in 1984. The declines among various categories of equipment were broadly based, but petroleum-related activities were responsible for the intensity of the decline. Oil companies are continuing to pare back their capital and exploration budgets. As one sign of the shift in the fortunes of the oil service industry, the number of rotary rigs in operation in the United States fell from about 4,500 late in 1981 to 1,950 in December 1985 and then plunged to 825 recently. In general, the outlook for capital spending near-term remains guarded, but at least the non-petroleum components may face improved demand if overall economic growth picks up later this year, as expected. The outlook has become cloudier of late because of recent developments in tax reform. It now appears that the investment tax credit will indeed be eliminated, but its effect may be partially offset by a more accelerated depreciation schedule for equipment. Although tax reform has definite positive attributes, whatever legislation is finally enacted will at least initially be detrimental to certain types of capital expenditures.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual					Forecast			Actual	Forecast	
	1985				1986				1983-	1984-	1985-
	I	II	III	IV	I	II	III	IV	1984	1985	1986
Gross National Product	6.9	4.5	5.8	4.3	5.8	4.6	7.3	8.8	11.0	5.7	5.6
Real GNP	3.7	1.1	3.0	0.7	3.2	2.8	4.2	4.0	6.6	2.2	2.7
GNP Price Deflator	3.0	3.3	2.9	3.3	2.5	1.9	3.0	4.7	4.0	3.3	2.9

	Actual	Forecast	Actual	Forecast
	1986: I	1986: II	1983-1984	1984-1985	1985-1986
Consumer Spending	5.5%	5.3%	8.7%	6.6%	5.7%
Durable Goods	0.4	7.7	14.3	9.2	2.0
Nondurable Goods	-1.8	2.1	6.8	4.6	4.8
Services	7.5	6.7	8.6	7.3	7.2
Business Capital Spending	-10.1	-2.8	20.1	11.3	0.3
Structures	-0.7	-0.5	17.0	15.3	2.2
Equipment	-14.9	-4.1	21.7	9.2	-0.7
Residential Investment	13.5	20.3	17.8	3.6	14.4
			1984	1985	1986
Change in Inventories	$29.7b.	$12.0b.	$67.1b.	$7.5b.	$18.9b.
Net Exports of Goods and Services	$-95.1b.	$-83.3b.	$-59.2b.	$-78.5b.	$-82.3b.
			1983-1984	1984-1985	1985-1986
Government Purchases	-10.8%	6.2%	9.0%	10.7%	5.1%
Federal	-28.1	8.0	9.9	13.6	3.1
Defense	- 7.8	4.9	9.9	10.5	4.6
Other	-63.2	18.0	9.8	23.2	-1.4
State & Local	5.4	4.8	8.4	8.5	6.3
Corporate Profits Before Tax	4.2F*	7.6*	15.9	-5.2	7.2
Corporate Profits After Tax	4.0F*	7.0*	10.9	-2.6	6.7
Plant and Equipment Expenditures	-6.9F	10.7	16.3	8.4	2.3
Real Final Sales#	-0.4	4.7	4.5	3.9	2.4
Real Disposable Personal Income	5.6	3.5	5.7	1.6	3.4

Economic Indicators	Recent Data			Actual	Forecast
	Jan.	Feb.	Mar.	1983-1984	1984-1985	1985-1986
Consumer Price Index**	3.6%	-4.8%	-4.8%	4.0%	3.8%	2.7%
Producer Price Index for Finished Goods**	-8.4	-19.2	-13.2	1.7	1.8	0.1
Industrial Production	0.2	-0.7	-0.5	11.5	2.2	2.1
Retail Sales##	-0.2	0.1	-0.8	10.5	6.5	3.8
				1984	1985	1986
Auto Sales (millions of units, a.r.)	11.5	10.7	9.6	10.4	11.1	10.7
Housing Starts (millions of units, a.r.)	2.03	1.99	1.95	1.75	1.73	1.88
Unemployment Rate	6.7%	7.3%	7.2%	7.5%	7.2%	6.7%
Merchandise Trade Deficit (a.r.)	$197.5b.	$149.9b.	$174.3b.	$127.6b.	$144.6b.	$155.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast

May 12, 1986